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No. 90-516

Supreme Court, U.S.  
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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1990

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JILL S. KAMEN,

*Petitioner,*

v.

KEMPER FINANCIAL SERVICES, INC. and  
CASH EQUIVALENT FUND, INC.,

*Respondents.*

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On Writ of Certiorari  
To The United States Court of Appeals  
For The Seventh Circuit

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**BRIEF OF RESPONDENT  
KEMPER FINANCIAL SERVICES, INC.**

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## QUESTIONS PRESENTED

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1. Whether both courts below erred in holding that the conclusory allegations in petitioner's complaint were insufficient to excuse her failure to make a demand before initiating this suit, in which petitioner alleges no fraud by the Fund or KFS, but claims only that certain correct, but allegedly "misleading," information was included in proxy materials distributed to the Fund's shareholders.

2. Whether, as a matter of federal common law and policy, the futility exception to the demand requirement should be abolished in federal question cases, to protect the demand requirement from being swallowed up by the exception, to eliminate unnecessary and time-consuming satellite litigation over the question whether demand should be excused in particular circumstances, and to ensure that corporate directors will be permitted in the first instance to address shareholder complaints before a derivative action may be filed in federal court.

## RULE 29.1 LISTING

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The following are parent corporations and subsidiaries  
(not wholly owned) of Kemper Financial Services, Inc.:

*Parent Corporations:*

Kemper Financial Companies, Inc.  
Kemper Corporation  
Lumbermens Mutual Casualty Company

*Subsidiaries Not Wholly Owned:*

Dimensional Fund Advisers, Inc.  
Investors Fiduciary Trust Company  
Kemper International Management, Inc.  
BSN Gestion de Patrimonios, S.A.

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## STATUTES AND RULES INVOLVED

In addition to the statutes and rules cited by petitioner, this case involves Sections 80a-2(a)(19)(B), 80a-10(a), and 80a-15(c) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-2(a)(19)(B), 80a-10(a), and 80a-15(c), which are set forth in an appendix to this brief.

## STATEMENT OF THE CASE

### 1. The Parties

Petitioner Jill S. Kamen is a shareholder in respondent Cash Equivalent Fund, Inc. (the "Fund"), a money market mutual fund registered as an investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* ("the 1940 Act") (J.A. 38-39). Respondent Kemper Financial Services, Inc. ("KFS") is the investment adviser and underwriter of the Fund (J.A. 40).

The Fund is designed to provide cash management services to clients of broker-dealers (R. 64, Ex. B at 2). The Fund differs from "retail" money market mutual funds such as Kemper Money Market Fund ("KMMF"), and provides specialized services that typically are not available from a retail money market fund.<sup>1</sup> The Fund is designed for investors who want the added services the Fund provides and are willing to pay for these services in the form of somewhat higher fees and lower yields (C.A.J.A. 178-82, 185).<sup>2</sup>

<sup>1</sup> These services include cash management capabilities to invest, redeem, and transfer funds automatically, thereby insuring that an investor can earn income while awaiting investment decisions and pay for investments without writing checks (J.A. 93-94). Certain broker-dealers also offer check writing privileges and related services (R. 64, Ex. B at 7).

<sup>2</sup> "C.A.J.A." refers to the joint appendix filed in the court of appeals. "C.A. Br." and "C.A.R. Br." refer, respectively, to petitioner's opening and reply briefs in the court of appeals.

At the time suit was filed, the Fund had 10 directors (J.A. 101-03). Only three were "interested persons," *i.e.*, persons affiliated with the Fund, its investment adviser, underwriter, or legal counsel; the other seven directors were wholly independent (*id.*). The Fund's percentage of independent directors exceeded that required by the 1940 Act. *See* 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19)(B).

## 2. District Court Proceedings

On May 10, 1985, petitioner filed a one-count complaint "on behalf of the Fund," asserting claims against KFS and the Fund under Sections 20(a) and 36(b) of the 1940 Act, 15 U.S.C. §§ 80a-20(a), 80a-35(b). The complaint alleged that KFS had violated the proxy provisions of Section 20(a) and breached its fiduciary duty under Section 36(b) by charging excessive investment advisory fees (J.A. 9-16).

The purported proxy violation stems from one sentence in a proxy statement distributed in 1984, seeking continued approval of the fees charged by KFS. That sentence stated that KFS charged KMMF "a maximum fee of .50 of 1% of the first \$215,000,000 with lesser rates on additional assets" (J.A. 13). This sentence appeared in a section of the proxy statement, which, in accordance with applicable regulations, listed the 14 other funds for which KFS also provided advisory services, as well as the rates charged to each (September 12, 1984 Proxy Statement of Cash Equivalent Fund, Inc. ("1984 Proxy") 6-7).<sup>3</sup> Although it accurately described the maximum fee that KFS charged to KMMF, petitioner contends that the statement "misleadingly described the fees charged" simply because it did not list the precise amount of the lesser rates

<sup>3</sup> The 1984 Proxy, as well as the November 5, 1985 Proxy Statement ("1985 Proxy") referred to herein (*see* p. 25, n. 17, *infra*), are not part of the record. Both, however, are public records (*see* 12 C.F.R. § 4.15(a)(7) (1990)) and thus may be judicially noticed. *See* Fed. R. Evid. 201; *Massachusetts v. Westcott*, 431 U.S. 322, 323 n.2 (1977) (*per curiam*); *Standard Havens Prods. v. Gencor Indus.*, 897 F.2d 511, 514 n.3 (Fed. Cir. 1990).

charged on additional assets (J.A. 13). Petitioner claims that the statement thereby "gave the false impression" that the fees charged to the Fund were lower than those charged to KMMF (*id.*).

Petitioner charged only KFS with improper conduct. She did not sue the Fund's directors individually. Nor did she allege that any director knew of the purportedly misleading statement. Moreover, petitioner did not allege that the statement was false, or that KFS's actions were fraudulent, intentional, or negligent.

The only "harm" purportedly caused by the alleged Section 20(a) violation was approval of the investment management agreement. The sole relief requested under Section 20(a) was return to the Fund of the allegedly excessive fees — the same relief sought under Section 36(b) (*see* J.A. 15). Petitioner's original complaint asserted no justification for failing to make a demand with respect to the Section 20(a) claim (J.A. 14). KFS moved to dismiss the Section 20(a) claim on two grounds: (1) petitioner had failed to make a demand, and (2) because petitioner only sought return of allegedly excessive fees, her claim was actionable only under Section 36(b), and not under Section 20(a) (R. 8).<sup>4</sup>

Petitioner conceded that the pleading requirements of Fed. R. Civ. P. 23.1 applied to her Section 20(a) claim (R. 16). Thus, petitioner filed an amended complaint which attempted to explain her failure to make a demand, alleging that demand would be futile because: (1) the seven non-interested directors on the 10-member board received "aggregate remuneration of approximately \$300,000 a year" for serving as directors of this and other funds; (2) the directors voted to send out the proxy statement; (3) a demand would be tantamount to asking the directors to sue themselves, and they

<sup>4</sup> The Fund joined in this motion and asserted that a demand should have been made (R. 11). However, the Fund took no position on the merits of the proxy violation allegations (J.A. 24-25).

would not prosecute litigation in an appropriate manner in any event; (4) the directors were "under the control" of KFS and Kemper Corporation; (5) the Fund had sought to dismiss the original complaint on "substantive grounds"; and (6) "federal policy" reasons disfavored application of the demand requirement in these circumstances (Pet. App. 92a-93a).<sup>5</sup>

KFS persisted in its motion to dismiss petitioner's amended complaint on the ground that the conclusory allegations upon which she sought to avoid demand did not satisfy the particularity requirements of Rule 23.1 (R. 21). On February 2, 1987, the district court dismissed petitioner's Section 20(a) claim, holding that her allegations did not comply with Rule 23.1 (Pet. App. 56a). After discarding petitioner's conclusory allegations, the court found that her futility argument rested on two contentions: (1) that the directors were compensated for their services, and (2) that they voted to distribute the allegedly misleading proxy statement. The district court concluded that these allegations were insufficient to excuse a demand.

Specifically, the district court found that petitioner's allegation concerning the directors' remuneration fell far short of demonstrating "futility" (Pet. App. 52a-53a):

The mere fact that the directors receive substantial remuneration for acting as directors does not, in and of itself, establish that they could not impartially review the merits of [petitioner's] excessive fee claim. If the fact that a director is paid for his services was sufficient to avoid Rule 23.1, Rule 23.1 would be rendered ineffective.

<sup>5</sup> Petitioner filed her amended complaint on July 23, 1985 (R. 17). On December 8, 1986, she filed a supplemental amended complaint (Pet. App. 85a-95a) which contains identical allegations concerning the proxy claim and the purported reasons that demand was futile. We will refer to the supplemental amended complaint.

The district court also found that futility was not established by petitioner's allegation that the directors had approved the proxy statement (Pet. App. 53a-54a; citations omitted):

The courts have consistently held that "mere approval of challenged conduct is insufficient to render the demand futile." . . . As the First Circuit aptly remarked, "It does not follow . . . that a director who merely made an erroneous business judgment in connection with what was plainly a corporate act will 'refuse to do [his] duty on behalf on [sic] the corporation if [he] were asked to do so.' Indeed, to excuse demand in these circumstances — majority of the board approval of an allegedly injurious corporate act — would lead to serious dilution of Rule 23.1."

Petitioner filed a motion to reconsider (J.A. 67-113). She did not argue that the court had erred by applying federal law to the demand requirement, or that the court should have applied Maryland law. Nor did petitioner cite any legal authorities to show that she had pleaded facts sufficient to excuse a demand (R. 66). Instead, petitioner attempted to support her position solely by referring to the allegations of her complaint and to excerpts from the depositions of five directors taken some 17 months after the complaint had been filed (J.A. 70-75). Although several of the directors indicated that they had then reviewed the complaint and believed that it had no merit (J.A. 72, 73, 76, 83), the directors who were asked also indicated that they would have considered the claim if a demand had been made (*e.g.*, J.A. 71, 85).

The district court denied the motion for reconsideration for two reasons (Pet. App. 61a-65a). First, the court concluded that the relevant question was not whether the directors would file suit, but whether they would be impartial in deciding whether to sue. The court found that petitioner had not alleged sufficient facts to show that the directors would not have acted properly, if petitioner had presented a

demand. Second, the court emphasized that futility is to be determined as of the time suit is commenced, not at some later time after adversarial positions may have hardened. "[T]he mere fact that the directors indicate their disagreement with the lawsuit after it is filed does not indicate that they would not have considered a timely demand" (Pet. App. 65a).

### 3. Seventh Circuit Proceedings

On appeal, petitioner argued that the dismissal of the Section 20(a) derivative claim should be reversed because her complaint pleaded facts sufficient to excuse demand. The Seventh Circuit disagreed, stating that the district court "thought [petitioner's] allegations insufficient to excuse a demand under Rule 23.1, as do we" (Pet. App. 6a).

After concurring in the district court's holding as to the inadequacy of petitioner's allegations of futility, the Seventh Circuit went on to hold that the futility exception should be eliminated as a matter of federal common law. Because futility was the only ground upon which petitioner attempted to justify her failure to make a demand, the court concluded that the Section 20(a) claim was properly dismissed for this reason as well (Pet. App. 20a).

The Seventh Circuit observed that the futility exception had generated such extensive and unproductive satellite litigation as to swallow the demand rule and "sap[] the potential role of the demand requirement as an alternative dispute resolution mechanism" (Pet. App. 14a). The Seventh Circuit further noted that other courts also had "display[ed] impatience with the futility exception" (Pet. App. 18a). In addition, the court determined that existing precedent did not mandate continued recognition of a futility exception in federal cases (Pet. App. 18a-20a). The court therefore concluded that the better rule would be for "claims of futility [to] be tested by *making* the demand rather than by arguing about hypotheticals" (Pet. App. 20a; emphasis in original).

The court of appeals also suggested that dispensing with the futility exception would allow the demand requirement to fulfill its proper function as an "exhaustion requirement" in federal law cases (Pet. App. 14a). In this way, the federal courts would not be burdened with litigation until directors had been given an opportunity to determine in the first instance what action, if any, should be taken on behalf of the corporation.<sup>6</sup> Thus, before a shareholder could file a lawsuit on behalf of the corporation, the directors would be permitted to consider whether to pursue litigation; whether the costs and disruption of litigation outweigh its benefits, which may be small or speculative; and whether to explore alternative means of dispute resolution (Pet. App. 9a-10a).

In the Seventh Circuit, petitioner again asserted that the relevant issues were controlled by federal law (C.A. Br. 14-15). In her reply brief, petitioner continued to argue that federal law was controlling, but also suggested, for the first time, that Maryland law should apply in the event that the court chose to apply state law (C.A.R. Br. 10). The Seventh Circuit held that federal law should be applied. In addition, however, the court treated petitioner's suggestion as if it were an affirmative assertion that Maryland law should apply, but held that the assertion "comes too late . . . ." (Pet. App. 9a).

This Court granted review limited to the question addressing the dismissal of the derivative claim under Section 20(a) for failure to make a demand.

<sup>6</sup> The Seventh Circuit noted that if a demand is made and "the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law" (Pet. App. 20a). The Seventh Circuit specifically rejected any link between a demand and the imposition of any particular standard of review with respect to the directors' response (Pet. App. 13a).

## INTRODUCTION AND SUMMARY OF ARGUMENT

1. The only question properly presented in this case is whether the court of appeals erred when it upheld the dismissal of petitioner's Section 20(a) claim on the two independent grounds that (1) petitioner had not pleaded facts sufficient to show that a demand would have been futile, and (2) as a matter of federal common law, futility should be abolished as an exception to the demand requirement. Although this is the only question properly presented on the pleadings and record in this case, petitioner and the Commission ask this Court to reach out and decide two questions which were never raised or decided below, which were not presented for review in the petition for certiorari, and which therefore should be left for another day.

First, the Commission suggests that the decisions below should be reversed on the theory that Section 20(a) actions cannot be derivative, and that no demand could therefore be required in this case. The Commission cites no relevant authority in support of this novel assertion, which is incorrect in any event. More important, petitioner and her experienced counsel have never made this argument in the district court, in the court of appeals, or in this Court. Whether Section 20(a) actions ever can be brought derivatively is not properly before the Court at this time.

Second, petitioner and the Commission both contend that the need for a demand in this Section 20(a) case is to be determined under Maryland, rather than federal, law. This, too, is an issue that is not properly presented for review. Petitioner never asserted in the district court that the issue was controlled by Maryland law. On the contrary, petitioner relied only on federal law. Similarly, petitioner's opening brief in the Seventh Circuit made no mention of Maryland law. Petitioner's only reference to Maryland law came in her reply brief, and she did not argue even then that Maryland law provided the rule of decision. She argued only that the

court of appeals should look to Maryland law in the event the court found that federal law was not controlling.

The Seventh Circuit held that federal law was controlling, but rejected petitioner's Maryland law argument on the additional ground that issues cannot be raised for the first time in a reply brief (Pet. App. 8a-9a). Petitioner and the Commission apparently believe that the court of appeals erred in applying that neutral and well-established rule. If this Court were to hold that the court of appeals had no right to determine that this issue was waived by virtue of petitioner's failure to raise it, if at all, until the reply brief, that holding would inflict fundamental, systemic damage on our appellate courts, which must remain free to insist on the orderly presentation of the cases before them.

2. Both courts below correctly concluded that the Section 20(a) claim should be dismissed for failure to plead facts sufficient to excuse demand. The district court gave effect to the principle that demand may be excused, if at all, only where the complaint alleges specific facts to show that the directors are incapable of exercising independent judgment. Where, as here, the complaint alleges no factual basis for asserting that the directors could not be fair and impartial, demand cannot be excused. The kind of "facts" petitioner alleged fail to satisfy the federal common law standards which the district court correctly applied. Nor would petitioner's allegations satisfy the law of Maryland.

Petitioner did not allege that any director did anything improper. The only "facts" which petitioner asserted were that the directors were compensated for their services, and that they voted to distribute the proxy materials. Both courts below properly concluded that the demand requirement effectively would be eliminated if such allegations were deemed sufficient to excuse demand.

The court of appeals affirmed the district court's holding that the Section 20(a) claim should be dismissed on the

ground that petitioner had not alleged facts sufficient to excuse demand. In addition, the court of appeals affirmed the dismissal on the separate ground that the futility exception was swallowing the demand requirement itself and therefore should be eliminated in federal law cases. The court of appeals reviewed the burgeoning body of case law addressing the futility exception, observing that enormous resources had been wasted in litigation over the hypothetical, but necessarily fact-specific, question whether a particular board would have acted properly if a demand had been made. The court of appeals recognized the growing dissatisfaction with the futility exception expressed in federal appellate decisions narrowly applying the exception, and in the recommendations of various expert organizations and commentators.

The court reasoned that demand, without a futility exception, would function as an exhaustion requirement that would eliminate unnecessary federal litigation and encourage intracorporate dispute resolution. Contrary to petitioner's frequent warnings, this rule does not sound the "death knell" for derivative litigation. The Seventh Circuit made clear that it was not deciding what effect the denial of a demand should have on a subsequent shareholder suit. The court decided only that federal courts should be permitted to address the question of futility based on the history of an actual request, rather than on speculation and guesswork.

The Seventh Circuit's decision, which admittedly went beyond where previous courts have ventured, was correct as a matter of federal law and policy. By eliminating futility as a reason to forego a demand on directors, the Seventh Circuit struck a balance that is correct in any event, but particularly appropriate with respect to a claim under the 1940 Act, which mandates that independent directors act as "watchdogs" over the Fund. The rule fashioned by the court of appeals, which

protects the federal courts from becoming embroiled in collateral litigation over hypothetical claims of "futility," promotes sound judicial administration and corporate governance.

## ARGUMENT

### I. BOTH COURTS BELOW PROPERLY DISMISSED THE SECTION 20(a) CLAIM BECAUSE PETITIONER FAILED TO PLEAD SUFFICIENT FACTS TO EXCUSE MAKING A DEMAND.

The courts below took somewhat different, but convergent paths. The district court found that petitioner had fallen far short of alleging with particularity facts sufficient to establish futility. The court of appeals agreed with the district court's analysis and adopted that holding as its own, but elected to go farther and hold that preservation of the demand requirement necessitated abolition of the futility exception in federal cases.<sup>7</sup>

The district court's decision has ample support in the record, as the court of appeals correctly held (Pet. App. 6a, 17a). Based upon a careful analysis of Paragraph 17, which contains petitioner's only allegations pertaining to futility (Pet. App. 92a-93a), the district court correctly found that the

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<sup>7</sup> Petitioner makes much of the fact that the court of appeals articulated a second basis to support the result reached by the district court, asserting that the court of appeals would not have issued "such a doctrinaire opinion if it could reach the same result by a less revolutionary route" (Pet. Br. 13). Petitioner's argument ignores the central fact that the court of appeals squarely adopted the district court's reasoning, stating that the district court "thought these allegations [of futility] insufficient to excuse a demand under Rule 23.1, as do we" (Pet. App. 6a). This is a point not lost on the Commission, which correctly states that the court of appeals agreed "with the district court that the petitioner's allegations of futility were inadequate" (SEC Br. 4).

particularity requirements of Rule 23.1 were not satisfied.<sup>8</sup> There is no basis for concluding that the district court abused its discretion. *See, e.g., Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1208 (9th Cir. 1980). Indeed, petitioner cannot cite a single federal or state case in which any court has excused a demand based on boilerplate allegations like those pleaded here.<sup>9</sup>

**A. Both Courts Below Followed Unanimous Case Law In Holding That The Facts Alleged In Petitioner's Complaint Did Not Establish That A Demand Would Be Futile.**

In the leading case of *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), the First Circuit succinctly stated the federal rule with respect to the sufficiency of facts pleaded to excuse the making of a demand. In that case, the court held that demand will be excused only upon a particularized showing that the directors have an antagonism for the corporate interest that renders them incapable of discharging their duties. *Id.* at 263.

<sup>8</sup> Whether the demand requirement rests on Rule 23.1 or the underlying substantive law, or both, is a question which this Court left open in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532-33 n.8 (1984); *but cf.* 464 U.S. at 543-44 (Stevens, J., concurring) (Rule 23.1 "concerns itself solely with the adequacy of the pleadings"). However, the requirement of pleading with particularity the reasons for not making a demand is an established exception to the liberal notice pleading rules generally applicable to federal complaints. *See In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976). Thus, the district court correctly looked to federal law insofar as it based its ruling on the insufficiency of the pleadings. *See* 7C C. Wright, A. Miller, M. Kane, *Federal Practice & Procedure* § 1831 at 100 (1986).

<sup>9</sup> Given the insubstantiality of petitioner's futility allegations, it is not surprising that she cites them but once in her brief (Pet. Br. 3-4), and does not even attempt to refute the unanimous case law holding such allegations insufficient to establish futility.

The *Kauffman* court rejected the plaintiff's conclusory assertions that demand was futile, that the majority, non-affiliated directors were under the control of the minority, and that the directors had been involved in the contested decision. The First Circuit explained that before taking the exceptional step of excusing demand, specific and compelling facts must be presented (*id.*; citation omitted):

[I]t is normally the directors, not the stockholders, who conduct the affairs of the company. Hence, to be allowed, *sua sponte*, to place himself in charge without first affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional. His initial burden is to demonstrate why the directors are incapable of doing their duty, or as the Court has put it, to show that "the antagonism between the directory and the corporate interest . . . be unmistakable."

Thus, a demand may be excused as futile only if the pleadings demonstrate with particularity that the directors are not disinterested and independent decisionmakers. *E.g., Graves*, 701 F.2d at 248; *Greenspun*, 634 F.2d at 1209-10. The shareholder may not merely state in conclusory terms that he made no demand because it would have been futile. *E.g., Greenspun*, 634 F.2d at 1209; *Kauffman*, 479 F.2d at 263.

The district court's decision in this case fully accords with federal precedent. When stripped of conclusory assertions, petitioner's complaint contains only two relevant factual allegations: (1) the directors were compensated for their services, and (2) they voted to send out the proxy solicitation. Neither is sufficient to excuse demand.

The district court correctly recognized that the demand requirement effectively would be eliminated if the mere payment of directors' fees were sufficient to excuse a demand (Pet. App. 53a). Here, petitioner did not even detail the fees

which the Fund paid to each director, but only stated the aggregate amount which all independent directors received from the various funds which they served as directors. In addition, petitioner did not allege that any director received a substantial portion of his income from fund-related director fees. Nor did she suggest that the payment of fees to the directors depended upon the way they voted. Petitioner simply attempted to impugn the integrity of the non-interested directors by asserting that they became "dependent upon and subservient to KFS and Kemper Corporation" merely by virtue of accepting a fee for their services (Pet. App. 92a). The district court correctly rejected this wholly unsupported conclusion which, if accepted, would lead to the absurd result that demand always would be deemed "futile" unless the directors served without compensation. *Accord Elfenbein v. Gulf & Western Indus.*, 590 F.2d 445, 450-51 (2d Cir. 1978); *Poland v. Caldwell*, 1990 WL 158479 (E.D. Pa. 1990) (available on Westlaw); *Shields ex rel. Sundstrand Corp. v. Erickson*, 710 F. Supp. 686, 692 (N.D. Ill. 1989); *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986).

Petitioner admits that only three of the Fund's 10 directors are "interested," but contends that demand nonetheless would have been futile because "[i]t would be tantamount to asking the directors to sue themselves" (Pet. App. 93a). Courts have deemed this same boilerplate allegation insufficient to excuse demand. *E.g., Graves*, 701 F.2d at 249; *Pullman-Peabody Co. v. Joy Mfg. Co.*, 662 F. Supp. 32, 35 (D.N.J. 1986). Petitioner's further allegation that the directors voted to distribute the proxy statement (Pet. App. 92a) also is insufficient to excuse her failure to make a demand. *E.g., Graves*, 701 F.2d at 248 (noting there is ample authority in the courts of appeals to establish that mere acquiescence is insufficient to excuse demand).

In addition, petitioner's complaint does not allege improper conduct by the Fund, but only by KFS. Because no

Fund director is alleged to have done anything improper, this action does not ask the board to sue itself. The only relief sought is the return to the Fund of allegedly excessive fees. If the directors, after considering the merits and other relevant factors, were to conclude that the Fund's overall interest would be advanced by pursuing the claim, they would have no motive for failing to do so.<sup>10</sup>

Petitioner suggests, as she did in the district court, that futility was established because several directors testified (some 17 months into the litigation) that petitioner's claims lacked merit (Pet. Br. 23-26). That argument is both factually misleading and legally irrelevant. As a factual matter, the Fund's initial answer took no position on the merits of petitioner's proxy claim (J.A. 25). Only months later did several individual directors indicate at depositions that they then believed, based on their review and knowledge of the facts, that the proxy claim lacked merit (J.A. 72, 73, 76, 83).

Moreover, in the deposition testimony quoted by petitioner, one director, David W. Belin, stated plainly that "if someone came to me as a shareholder and said they believed there was some merit [to a claim], at least I would give it some consideration" (Pet. Br. 25). Petitioner cannot point to any statement by Mr. Belin — or any other director — which

<sup>10</sup> Significantly, the complaint does not contain a single allegation that any Fund director knew of the allegedly misleading nature of the proxy statement at the time it was distributed. Nor does the complaint allege that any omission was the result of fraud by KFS or any Fund director. Thus, petitioner's mischaracterization of her case as one involving proxy "fraud" (see Pet. Br. i) — which she repeats no fewer than 11 times in her opening brief — has no basis in the complaint. Not only that, petitioner now goes so far as to suggest that "[t]he directors are the very perpetrators of the proxy fraud complained of" (Pet. Br. 5). Petitioner cannot amend her pleadings by unsupported statements in her brief. Indeed, petitioner already has amended her verified complaint twice, and she surely would have alleged "fraud" had she been able to do so, consistent with Fed. R. Civ. P. 11.

even implied that they would not have given fair consideration to petitioner's claim had a demand been made.<sup>11</sup>

At all events, this deposition testimony is irrelevant as a matter of law. *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). As the district court stated, both in its initial opinion and in its opinion on reconsideration (Pet. App. 54a-55a, 64a; citations omitted):

The futility of a demand should be gauged at the time the suit is commenced. . . . The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the shareholder had requested it to act.

The district court thus correctly applied the settled legal principle that assertions made after litigation has commenced, when positions may have hardened, say nothing about how a board would have reacted if it had been notified of a problem by a demand rather than a lawsuit.<sup>12</sup>

The correctness of the court's analysis is particularly obvious here, where the statutory policy of the 1940 Act underscores the need for faithful enforcement of the demand

<sup>11</sup> Indeed, the supplemental amended complaint (Pet. App. 85a-95a) makes no reference to the deposition testimony, although the depositions were concluded before it was filed.

<sup>12</sup> Contrary to petitioner's assertion (Pet. Br. 16-17 & n.8), neither this Court's decisions nor those of the Seventh Circuit establish that "post-litem board opposition is sufficient to excuse demand." In *Smith v. Sperling*, 354 U.S. 91 (1957), the sole issue was whether the corporation was to be realigned as a party plaintiff for jurisdictional purposes. As other courts have recognized, *Smith* did not involve allegations of post-litigation conduct. See *Kauffman*, 479 F.2d at 265 n.5; see also Pet. App. 18a-19a. In *Nussbacher v. Continental Ill. Nat'l Bank & Trust Co.*, 518 F.2d 873, 875 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976), which was overruled by the decision below, futility stemmed from pre-litigation conduct and comments.

requirement. A central purpose of the 1940 Act is to ensure the availability of neutral decisionmakers, both by limiting the percentage of directors who may be interested persons, within the broad definition of the Act, 15 U.S.C. § 80a-2(a)(19)(B), and by providing that only the disinterested directors may approve an investment adviser's contract, 15 U.S.C. §§ 80a-10(a), 80a-15(c). By implementing these requirements, Congress intended disinterested directors of mutual funds to be "independent watchdogs" over the funds. *Burks v. Lasker*, 441 U.S. 471, 484 (1979). Finding futility based on the conclusory and inadequate allegations in petitioner's complaint would have the undesirable effect of "muzzl[ing]" these watchdogs, *id.* at 485, and would encourage the filing of lawsuits without first allowing the disinterested directors to review the matter and consider, among other things, whether the controversy can be resolved in some less expensive and more efficient manner.

#### B. Petitioner's Allegations Would Not Be Sufficient To Excuse Demand Even Under Maryland Law.

Both courts below were correct in applying federal law. In addition, petitioner's eleventh-hour contention that her allegations would be sufficient to excuse demand under Maryland law is not properly before the Court.<sup>13</sup> Without waiving our objection, however, we will briefly address that argument to show that the judgment would have to be affirmed in any event, because petitioner's allegations are insufficient even under Maryland law.

Although Maryland law recognizes a futility exception, the standards for its application are essentially the same as those which have been applied in the past under federal law. See *Zimmerman v. Bell*, 585 F. Supp. 512, 514 (D. Md. 1984). A demand upon directors has been excused under

<sup>13</sup> As KFS demonstrates below (see pp. 34-41, *infra*), petitioner waived any claim that Maryland law applies in this case, and federal common law should apply in any event.

Maryland law only when the complaint alleges fraud, active participation in the wrongdoing, or conspiracy to violate federal law and regulations. *See, e.g., Parish v. Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512, 545 (Md. Ct. App. 1968) (directors sued individually for fraud, concealment, gross negligence, and waste of corporate assets), *cert. denied*, 404 U.S. 940 (1971); *Bell*, 585 F. Supp. at 514 (all members of board sued for active participation in wrongdoing); *Burt v. Danforth*, 742 F. Supp. 1043, 1048 (E.D. Mo. 1990) (applying Maryland law) (entire board allegedly engaged in conspiracy to violate federal law and regulations, including intentional and fraudulent activities).

At the same time, cases applying Maryland law make clear that mere allegations of negligent breach of fiduciary duty, interest due to compensation, and board control by interested parties cannot excuse demand. *See, e.g., Burt*, 742 F. Supp. at 1048; *cf. Rosengarten v. Buckley*, 565 F. Supp. 193, 198 (D. Md. 1982) (in a case involving shareholder demand, court stated that "a plaintiff may not escape the demand requirement by characterizing a suit which is really based on a breach of fiduciary duty as a fraud action").

In the case at bar, petitioner made no allegations which even approach those that have been found sufficient under Maryland law. It is understandable, therefore, that petitioner's argument under Maryland law (Pet. Br. 11-13) contains no reference to any of the actual allegations in her complaint, which she now attempts to recast as if they alleged fraud. However, petitioner does not advance her cause with this belated and transparent exercise in alchemy. As *Rosengarten* confirms, courts must look beyond the label to see whether in fact fraud is involved. *See* 565 F. Supp. at 198. In

this case, petitioner's present incantation of "fraud" cannot serve to reconstitute the allegations in her complaint.<sup>14</sup>

In the case at bar, petitioner filed three different verified complaints, the last of which came after substantial discovery had been completed. Even then, petitioner obviously did not believe that she could, in good faith, allege fraud; nor could she allege even a breach of fiduciary duty by any director. These pleadings cannot suffice to excuse demand under Maryland law, federal law, or any other law which petitioner might suggest in her reply brief.

## II. THE COURT OF APPEALS CORRECTLY HELD THAT THE FUTILITY EXCEPTION SHOULD NOT APPLY IN THIS DERIVATIVE ACTION UNDER SECTION 20(a) OF THE INVESTMENT COMPANY ACT OF 1940.

The court of appeals in this case adopted the straightforward rule that a shareholder must make a demand on the directors before filing a derivative action. The court reasoned that the futility exception (1) had engendered massive

<sup>14</sup> Petitioner takes considerable liberties not only in attempting to recast her complaint as one alleging "fraud" (*see* p. 15, n.10, *supra*), but also in describing the authorities that she cites. First, the *Parish* court did not hold that demand on the directors "was excused because the directors affirmed their support of management's action after the commencement of the law suit" (Pet. Br. 11). The cited portion of the opinion addressed demand upon shareholders, not directors. Moreover, the shareholders, not the directors, affirmed their support of management. 242 A.2d at 545-46. Second, petitioner cites *Bell*, apparently for the proposition that fraud vitiates the demand requirement (Pet. Br. 11), but she fails to mention that one of the intervening plaintiffs in *Bell* in fact had made a demand on the board, which had been refused. 585 F. Supp. at 514. Third, petitioner devotes considerable attention to *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978) (Pet. Br. 11-12), but that case purported to apply federal law, not Maryland law, in the cited passage addressing director demand. *See* 77 F.R.D. at 739-40. The *Oldfield* court applied Maryland law only to the issue of demand on shareholders, which was addressed separately in the opinion.

amounts of unnecessary and time-consuming federal litigation over the collateral issue of whether a demand would have been futile, (2) had thereby created a substantial danger that the futility exception would swallow up the demand rule, and (3) had eviscerated the demand requirement as an effective intracorporate means of resolving shareholder disputes.

By dispensing with the futility exception in federal law cases, the court of appeals sought to preserve the demand requirement and permit it to fulfill its proper function as an exhaustion requirement. The court rejected the futility exception only after thoroughly considering relevant legal principles and policy considerations, all of which led to the common sense conclusion that "claims of futility should be tested by *making* the demand rather than by arguing about hypotheticals" (Pet. App. 20a; emphasis in original).

Contrary to petitioner's assertions, rejection of futility as an exception to the demand requirement is neither "doctrinaire" nor "revolutionary" (Pet. Br. 13), but a proper and measured exercise of the power of the federal courts to establish prerequisites ensuring that judicial resources are not squandered on collateral or hypothetical matters. The Seventh Circuit correctly determined that changed circumstances and the necessary evolution of federal common law warrant elimination of futility as an exception to the demand requirement, itself a creature of the federal common law.

**A. Abolishing The Futility Exception Benefits The Judicial System And Promotes Intracorporate Dispute Resolution Without Unduly Burdening Plaintiffs.**

**1. Judicial Economy Favors Elimination of the Futility Exception.**

The demand requirement stems, in significant part, from this Court's recognition of the need to regulate the circumstances in which the doors of the federal courts should be opened for derivative claims. In *Hawes v. Oakland*, 104 U.S.

450 (1881), this Court recounted the potential abuses inherent in derivative litigation. The Court was concerned not only that derivative actions, if left unconstrained, could undermine the ability of directors to consider shareholder claims in the first instance, *id.* at 454-57, but also that parties might collusively manufacture diversity jurisdiction and thus unnecessarily burden the federal courts. *Id.* at 452-53. The Court's concern did not rest solely in protecting corporations from unnecessary litigation, but also in ensuring that the resources of the federal courts would be devoted to hearing only those cases which required federal judicial action.

In *Hawes*, the Court took aim at both potential abuses when it instituted demand as an exhaustion requirement (*id.* at 460-61):

[B]efore the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.

The Court thus contemplated that derivative suits would be "a limited exception to the usual rule that the proper party to bring a claim on behalf of a corporation is the corporation itself." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 531 (1984).

In the intervening 110 years, the futility exception has evolved in a way that has robbed the demand rule of its vitality as an exhaustion requirement. In the *Hawes* era, the federal courts required protection from parties who would foist upon the courts derivative suits with manufactured diversity jurisdiction. Today, the burden on federal courts

comes from the use of the futility exception to avoid recourse to intracorporate means of dispute resolution. As the Seventh Circuit recognized, the futility exception has produced "gobs of litigation" and "[h]undreds of cases opine on whether demand is or is not futile" (Pet. App. 14a).

This multiplicity of collateral litigation is virtually unavoidable under the futility exception. The exception is premised on the view that, if the board is "biased" against bringing suit or taking other appropriate action, then a demand would be useless. Thus, the threshold issue for maintaining a derivative action has become whether bias can be presumed (and demand excused) because of the directors' involvement in the actions being challenged, their alleged misconduct, or their personal relationships with those persons whose conduct is being challenged. Answering this hypothetical, but fact-specific question has been a time-consuming process.

The Seventh Circuit is not alone in recognizing this problem, and the threat that it poses for an already overburdened federal judiciary. The American Law Institute ("ALI"), in recommending abolition of the futility exception, has noted that "[w]hatever the standard used to state the futility exception, close questions are inevitable and consequent litigation predictable over the necessity for demand." ALI, *Principles of Corporate Governance: Analysis and Recommendations* ("Principles of Corporate Governance") § 7.03, Comment at 64 (Tent. Draft No. 8, 1988). Likewise, the American Bar Association Section of Business Law Committee on Corporate Laws ("ABA") has concluded that eliminating the futility exception is desirable because it "eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required." ABA, *Revised Model Business Corporation Act* § 7.42 at 212-13 (1990) (Official Comment).

The rule adopted by the court of appeals will restore vitality to the demand requirement and promote judicial

economy. If demand leads to the matter being resolved to the shareholder's satisfaction without litigation, that is the best result of all. If litigation ensues notwithstanding a demand, the litigation at least will focus on questions deserving of judicial attention. In either case, requiring demand is preferable to expending vast amounts of time, money, and scarce judicial resources in litigating the hypothetical question whether demand would have been futile.<sup>15</sup>

## 2. Intracorporate Dispute Resolution Is Advanced By Eliminating The Futility Exception.

The futility exception is based on the theory that a board, in certain exceptional circumstances, may be incapable of rendering a fair and unbiased decision when presented with a demand. In practice, however, the futility exception has been employed routinely as an excuse to avoid allowing a board to consider whether a shareholder grievance warrants no action at all, the filing of a lawsuit by the corporation, or the pursuit of alternative remedies which may be more beneficial than litigation for the corporation and its shareholders.

Shareholder-plaintiffs and their counsel assume that whenever a "wrong" exists, the "wrong" must be redressed at all costs and only by litigation (see Pet. App. 16a). Permitting a shareholder-plaintiff to act as if these assumptions were valid, however, brings the futility exception into direct conflict with an important purpose of the demand requirement: to give directors the opportunity to make an informed judgment — before suit is filed by a shareholder — as to whether to commit the resources of the corporation to a lawsuit, or,

<sup>15</sup> The Commission concedes (SEC Br. 24-25 n.23), and KFS agrees, that this case presents no question as to the proper standard of review to be applied to the directors' decision, once a demand has been made and declined.

alternatively, to attempt other less costly ways of addressing the grievance.<sup>16</sup>

When presented with a demand, directors have available a range of intracorporate options for addressing complaints while also avoiding unnecessary litigation. A chief reason that the ALI has recommended abolition of the futility exception, and one that was recognized and endorsed by the court of appeals (Pet. App. 14a), is to encourage implementation of this wide range of intracorporate dispute resolution techniques. ALI, *Principles of Corporate Governance* § 7.03, Comment at 67.

Even when the majority of a board has been involved in the questioned transaction, a variety of corporate responses are available. For example, the board may appoint disinterested directors to a special litigation committee, to review the transaction. See, e.g., *Gaines v. Haughton*, 645 F.2d 761, 767-68 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982); 13 Fletcher, *Cyclopedia of the Law of Private Corporations* § 6019.50 (1984). If most or all the directors are or may be implicated in the questioned transaction, the board may appoint new directors to review the transaction or request the appointment of a special panel outside the corporation. See, e.g., *In re General Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1078-79 (6th Cir.), cert. denied, 469 U.S. 858 (1984); *Haughton*, 645 F.2d at 766-67.

<sup>16</sup> Indeed, it is widely acknowledged that shareholder derivative actions may take the form of strike suits, motivated not by a desire "to remedy wrongs to the corporation, but to induce settlement beneficial to the named plaintiff or his counsel." *Cramer*, 582 F.2d at 275; see also W. Klein & J. Coffee, *Business Organization and Finance* 165 (2d ed. 1986); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L. Rev. 746, 749 (1960); 7C C. Wright, A. Miller, M. Kane, *Federal Practice & Procedure* § 1831 at 119 (1986). The Seventh Circuit also observed that shareholder-plaintiffs and their counsel may allege futility, and thus seek to avoid a demand, only for the improper reason that a demand might lead to corporate action that would "deprive counsel of fees" (Pet. App. 13a).

In other circumstances, even an interested board may wish to take action, rather than engage in costly litigation on matters which it deems insignificant. The Revised Model Business Corporation Act has eliminated the futility exception precisely for this reason: "[E]ven though no director may be independent, the demand will give the board of directors the opportunity to reexamine the act complained of in light of a potential lawsuit and take corrective action." ABA, *Revised Model Business Corporation Act* § 7.42 at 212 (1990) (Official Comment). As the Seventh Circuit noted in the case at bar (Pet. App. 15a):

Although directors are unlikely to sue themselves, they may well take some action to palliate the consequences of poorly conceived acts, including their own. Directors want the venture to succeed, and if shown how they can improve its prospects, are likely to act. One mistake at the time of the initial board decision does not imply that the member of the board opposes remedial action.

In addition, the board may pursue internal corrective remedies not available to the plaintiff in a derivative action. "Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation." *Graves*, 701 F.2d at 247 (citation omitted).<sup>17</sup> As another alternative, the board might

<sup>17</sup> Indeed, if petitioner at bar had notified the board in a timely manner, the board might well have taken action that would have avoided this lengthy and expensive suit. For example, if petitioner had objected to the proxy materials before the shareholders' meeting, a new proxy statement could have been distributed. Even if the objection had been interposed at a later date, the board could have held a special shareholders' meeting. Given the expense of litigation, a board may wish to take such minimal action, even if it would not be required to do so. In fact, the Fund's subsequent proxies have set forth a detailed breakdown of the advisory fees which KFS charged to KMMF (see 1985 Proxy at 12; see also C.A.J.A. 188). Based on those solicitations, the shareholders have approved KFS's fees, as well as a fee increase.

either enter into a settlement that moots the issue or bring to the plaintiff's attention facts sufficient to show that the lawsuit is not worth pursuing.

Requiring demand, even when it may appear futile, allows a board to pursue these — and perhaps other — intra-corporate remedies. These remedies may allow the board to resolve a complaint satisfactorily, and thus avoid the enormous expense, time, delay, and diversion from productive business activities which result from improvident litigation. Giving the board the opportunity to consider these remedies also will relieve the federal courts of the burden of adjudicating disputes that need never have been filed.

### 3. Plaintiffs With Legitimate Grievances Are Not Unduly Burdened By The Rule Adopted By The Court of Appeals In This Case.

Petitioner objects to the Seventh Circuit's purported application of "quasi-functional analysis" (Pet. Br. 18); disagrees with the Seventh Circuit's assertion that making a demand is a "cheap and quick expedient" (Pet. Br. 19); and argues that requiring demand will put plaintiffs out of court (Pet. Br. 21-23). Petitioner's argument is based on the faulty premise that the federal courts, having required the making of a demand in federal question cases, necessarily will adopt a deferential standard of review for assessing the reasonableness of a board's decision not to sue. However, the Seventh Circuit specifically rejected any notion that the mere making of a demand automatically would require application of a deferential standard of review.

The Seventh Circuit observed that "[f]ederal courts have never embraced Delaware's link between the making of a demand and special deference to the board's decision not to sue . . . [and] [w]e think it would be unwise to do so" (Pet.

App. 12a).<sup>18</sup> Echoing the ALI's judgment that "the need for demand and the standard of judicial review — are logically very distinct," ALI, *Principles of Corporate Governance* § 7.03, Comment at 65, the Seventh Circuit concluded that "when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue" (Pet. App. 13a). Thus, petitioner's prediction of doom is far wide of the mark.<sup>19</sup>

Even petitioner recognizes that the only possible "cost" that may be incurred by requiring demand is the inability to file or maintain suit. That cost is minimal and speculative, however, because demand is separated from the subsequent

<sup>18</sup> Thus, the Commission's discussion of standards of review under Delaware law (SEC Br. 21-23) is particularly irrelevant. No party ever has suggested the applicability of Delaware law.

<sup>19</sup> As the Seventh Circuit made clear (*see* Pet. App. 12a-13a, 17a, 20a), its decision did not accept, reject, or alter any particular standard of review. Thus, the Commission is incorrect in its assertion (SEC Br. 21) that eliminating the futility exception will create confusion about standards of review under state law. The Seventh Circuit plainly stated that in a case where a demand is made and the board declines to sue, "the court can decide whether the board's decision is entitled to respect under state corporate law" (Pet. App. 20a), whatever that law may be. The Commission obscures this point by mischaracterizing the Seventh Circuit's abolition of the futility exception as if it involved the adoption of a "universal demand" requirement (*e.g.*, SEC Br. 21), a term frequently used to describe the ABA and ALI formulations. In this way, the Commission misleadingly implies that the Seventh Circuit also adopted the standards of review contained in those formulations. Eliminating the futility exception to the demand requirement in federal cases will not require federal courts to import the standards of review suggested by the ABA or ALI; nor will it "undermine" state laws that consider futility in determining the applicable standard of review (SEC Br. 23). The Seventh Circuit only dispensed with hypothetical "futility" as a reason not to make a demand; the court made clear that evidence which could demonstrate futility in fact would be relevant in applying the standard of review (Pet. App. 17a). Basing decisions on facts, not guesswork, is the customary mode of judicial decisionmaking and will reduce rather than create confusion.

scope of review to be applied if demand is denied. Requiring demand will lead to an examination of the merits at an earlier stage (when a court reviews a board's actual, rather than hypothetical decision), a result which harms no one. *E.g.*, ALI, *Principles of Corporate Governance* § 7.03, Comment at 65. If the directors are so involved in the transaction that demand indeed would be futile, the directors would merely reject the request, the plaintiff would lose no ground in making the demand, and the case would proceed in the courts.<sup>20</sup> In contrast, disputes over futility can delay resolution of the merits for many years, with significant costs to the courts and the parties.

The difficulty comes only from trying to divine futility in the absence of an actual demand. As the Seventh Circuit aptly noted, "[i]t is easy for the plaintiffs to say (and for the defendants to deny) that the board has a closed mind; it is much harder to tell who is right" (Pet. App. 16a; emphasis in original). Requiring demand eliminates that guesswork and allows any ensuing litigation to proceed, as litigation generally does, on the basis of actual facts rather than hypotheticals.

#### **B. Abolishing The Futility Exception Is A Natural Evolution Of Federal Common Law.**

In *Hawes*, this Court created the federal common law rule that a shareholder must exhaust his remedies by making a demand on the board of directors prior to commencing a

<sup>20</sup> Petitioner claims that this view is "naive," and that requiring demand would cause shareholder grievances to languish in special litigation committees for years (Pet. Br. 19-21 & n.9). However, petitioner ignores the fact that directors, particularly under the 1940 Act, are subject to standards of behavior which "apply as much to their decisions regarding litigation as to the other decisions they may be called upon to make." *Burks*, 441 U.S. at 481-82 n.10 (citations omitted). These standards provide directors with substantial incentive to act properly and expeditiously with regard to a demand. It is not "naive" to trust that shareholders will take action against directors who might attempt to choke off claims by neglect. Nor is it "naive" to believe that federal courts will enforce these standards against such directors.

derivative action. 104 U.S. at 460-61. The Court's subsequent decisions in *Doctor v. Harrington*, 196 U.S. 579 (1905), and *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435 (1909), may be read to assume the existence of a futility exception, but continued recognition of such an exception is not required because neither of these cases, nor any other decision of this Court, has squarely held that this exception should be recognized under federal common law (Pet. App. 18a-20a). Moreover, as the court of appeals also correctly noted, the *Doctor* and *Susquehanna* decisions are "linked" to their time, and to then-prevailing assumptions concerning corporate governance which no longer are valid.

The entire context of business regulation and governance, including the decisionmaking procedures of corporate directors, has changed dramatically in the past 85 years. The period from 1890 until the New Deal (dates which bracket the *Doctor* and *Susquehanna* decisions), when regulation of business corporations was principally a matter of state law, was a free-wheeling period. Public policy "carried the utilitarian attitude about as far as it could go: if the law of corporate organization was legitimated by its utility to business enterprise, legitimacy would be most fully achieved if the law empowered businessmen to create whatever arrangements they found most serviceable." J. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* 70 (1970).

These public policy values led to the relaxation or abandonment of state law limits "which the 1880's-type statutes had imposed in behalf of investors, creditors, and general social interests," and thus "reduced the opportunity of creditors or stockholders to police corporate legitimacy through provisions embodied in the corporate structure itself." *Id.* at 70, 160. In turn, these changes "legitimized control by the active [corporate] insiders — promoters, entrepreneurs, top management — who would wield the authority." *Id.* at 70-71. See also A. Berle & G. Means, *The Modern Corporation and*

*Private Property* 138 (1932). In short, the policy of state corporation law from 1890 to 1930 "was to enable businessmen to act, not to police their action." Hurst, *supra*, at 70. In these circumstances, it is understandable that a federal court might not invariably have required a demand to be made.

However, the whole thrust of public policy and legal doctrine changed drastically during the New Deal. With the enactment of the 1940 Act and other federal regulatory schemes,<sup>21</sup> the federal government exposed "corporate decision making to a public accountability unmatched in state law." *Id.* at 91-92. The result has been the creation of standards of conduct which, as this Court has recognized, "apply as much to [corporate] decisions regarding litigation as to the other decisions they may be called upon to make." *Burks*, 441 U.S. at 481-82 n.10 (citations omitted). These and other standards, in turn, have provided the impetus for developments in corporate governance, such as special litigation committees and the appointment of new directors or outside panels to review questioned transactions, to better ensure compliance with these standards.

As the Seventh Circuit correctly observed, these legal standards and mechanisms for corporate decisionmaking were not part of the landscape when *Doctor* and *Susquehanna* assumed the need for a futility exception (Pet. App. 19a-20a). Boards of directors did not use — and were not required to use — committees of disinterested directors to decide matters relating to interested directors. Certainly, no corporate entities were then required to conduct their activities, as is the Fund by virtue of the 1940 Act, through a board which has a substantial percentage of independent directors (*see pp. 16-17, supra*). In sum, this Court has never endorsed a futility exception within the present framework of extensive federal regulation which has come into existence only in the past 60 years. Nor should it do so now.

<sup>21</sup> *E.g.*, Securities Act of 1933, 15 U.S.C. § 77a *et seq.*; Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.*

The Seventh Circuit, in an effort to improve judicial administration, determined that the futility exception should be abolished. Rather than being "revolutionary" (Pet. Br. 13), the Seventh Circuit's decision reflects a change which stands squarely in the tradition of the common law and has the important and inherently conservative purpose of preserving the demand requirement against erosion.

As the Seventh Circuit noted (Pet. App. 18a), its decision follows from several decisions in which the courts of appeals have expressed impatience with the futility exception.<sup>22</sup> The Seventh Circuit is not alone in noting this trend. The ALI likewise has observed the "recent trend" of federal courts "to require demand in circumstances where the case law of an earlier generation would have excused it." ALI, *Principles of Corporate Governance* § 7.03, Reporter's Note at 76 (citations omitted). In addition, three states recently have eliminated the futility exception.<sup>23</sup>

Many knowledgeable voices have joined together in urging that the futility exception be abolished. The ALI, for example, has recommended that the demand requirement should simply be understood as an exhaustion requirement. *Id.* § 7.03, Comment at 64-71. Tentative Draft Number 8 proposes that a derivative action may not be commenced until the shareholder has made "a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective action, unless . . . the [shareholder] makes a specific showing that irreparable injury to the corporation would otherwise result." *Id.*

<sup>22</sup> Although other courts of appeals have not dispensed with the exception altogether, they have been "creative in denying that a demand would be futile even when it is pellucid that the board is not about to authorize a suit" (Pet. App. 18a; citations omitted).

<sup>23</sup> *See* Fla. Gen. Corp. Law § 607.0740(2) (1989); Ga. Bus. Corp. Code § 14-2-742 (1990); Mich. Bus. Corp. Act § 450.1493a(a) (1989).

§§ 7.03(a), (b) at 63-64. Similarly, the Revised Model Business Corporation Act provides categorically that “[n]o shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action . . . .” ABA, *Revised Model Business Corporation Act* § 7.42 at 212 (1990).

As the ALI and the ABA have recognized, abolishing futility as a reason to forego demand will accomplish two interrelated purposes: (1) eliminating the time and expense of litigating collateral issues relating to the hypothetical futility of demand, and (2) promoting intracorporate resolution of the dispute. On the other hand, retaining the futility exception would greatly endanger the continued viability of the demand requirement itself.

Petitioner rejects the force of these conclusions, grounding her approach on the extreme view that directors cannot be trusted to consider a complaint fairly or take appropriate action. This view no doubt nurtures petitioner’s “concern” that all directors are lying in wait to quash shareholder complaints (*see* Pet. Br. 19-23). Petitioner’s view speaks volumes as to why the futility exception has generated such a cottage industry of collateral litigation. If shareholder-plaintiffs and their counsel consider directors invariably untrustworthy, then it follows that they will consider demand to be invariably futile. Thus, shareholders (or their lawyers, as the court of appeals noted) rush to the courthouse to file suits, without first making a demand that might allow the matter to be resolved without litigation (*see* Pet. App. 13a).

Petitioner’s view is fundamentally distorted because it ignores the vast changes that have occurred since the turn of the century in the ways in which corporations are regulated and corporate decisions are made. These developments have undercut any need for the futility exception as a safeguard against the possibility that a board of directors might fail to deal fairly with a shareholder demand. The impact of these

developments is particularly obvious here, where a substantial majority of the Fund’s directors — seven out of 10 — are independent. There is no reasonable basis for presuming that these directors would not have fairly considered a demand, if petitioner had made one, or that petitioner would have lacked adequate remedies in that event.

The genius of the common law has been its capacity to adapt and meet the needs of a changing society. Thus, as Justice Cardozo has observed (B. Cardozo, *The Nature of the Judicial Process* 28 (1921) (emphasis in original)):

[A judge] must first extract from the precedents the underlying principle, the *ratio decidendi*; he must then determine the path or direction along which the principle is to move and develop, if it is not to wither and die.

*See also Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 731-32 (1988).

The court of appeals correctly recognized that the time has come for the federal common law to confront the futility exception’s corrosive effect on the demand requirement. This Court should adopt the rule articulated by the Seventh Circuit and thereby preserve the efficacy of the demand requirement.<sup>24</sup>

<sup>24</sup> Eliminating the futility exception in federal law cases does not conflict with the language of Rule 23.1 or in any way render the rule a nullity. Rule 23.1 implies the existence of situations in which a demand may be excused by providing that a plaintiff must allege with particularity that a demand was made or the reasons “for not making the effort.” To understand the correct meaning of the latter phrase, however, one must remember that Rule 23.1 applies in all derivative cases brought in federal court, which includes actions under state statutory or common law (where demand might be excused) as well as those brought under federal law. Thus, the language of Rule 23.1 is broad enough to cover both types of cases. In addition, the phrase “for not making the effort” might cover cases involving demand on *shareholders*, *see Hawes*, 104 U.S. at 461, a matter not presented in this case.

(footnote continues)

### III. BOTH COURTS BELOW PROPERLY RELIED UPON FEDERAL LAW.

In this Court, petitioner claims that federal law should not have been applied in this case, and that her allegations of futility should be evaluated under Maryland law (Pet. Br. 8-13). Petitioner's argument lacks merit for two reasons. First, petitioner never suggested the possibility that Maryland law might apply until her reply brief in the court of appeals. Even then, she affirmatively urged the court to apply federal law, rather than Maryland law, to the demand question. Thus, petitioner has waived any reliance on Maryland law.

Second, even if the issue had not been waived, the court of appeals was correct in holding that federal law is controlling. A uniform federal rule is required in this case because: (1) the demand requirement essentially is an exhaustion of remedies requirement, which is derived from federal common law, and does not directly involve the substantive powers of the board of directors; and (2) given the substantial federal regulation of mutual funds and their investment advisers, federal policy requires a uniform federal rule of law.

#### A. Petitioner Induced Both Courts Below To Apply Federal Law And Waived Any Argument That Maryland Law Applies.

Petitioner filed no pleading in the district court suggesting that Maryland law, rather than federal law, should govern the demand question. Everything filed by petitioner in the district court suggested that federal law should apply. For

(footnote continued)

At all events, Rule 23.1 was promulgated to effectuate administration of the demand requirement that this Court created in *Hawes*, and not to limit the Court's authority to adjust that requirement. See *Fox*, 464 U.S. at 543 (Stevens, J., concurring); see also *Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 444 (1946) (addressing Rule 4(f), the Court stated that "[t]he fact that this Court promulgated the rules as formulated and recommended by the Advisory Committee does not foreclose consideration of their validity, meaning or consistency").

example, petitioner's amended complaint alleged that, given her allegations of futility, "application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act" (Pet. App. 93a).<sup>25</sup>

Petitioner's opening brief in the court of appeals contained five pages of argument on the demand question (C.A. Br. 11-16). Petitioner did not argue that Maryland law should apply; on the contrary, she cited only two federal decisions applying federal law. The first mention of Maryland law appeared in her reply brief. Even there, petitioner asserted only that the court should not rely on any federal cases which interpreted Delaware law. In addition, she asserted that "if federal law is not applied, then the law of the state of incorporation governs the demand requirement" (C.A.R. Br. 10). Petitioner never argued that the district court improperly applied federal law. In these circumstances, the Seventh Circuit properly found that petitioner waived any argument that Maryland law should apply.<sup>26</sup>

<sup>25</sup> At no time did petitioner cite any legal authority in support of this assertion, which is incorrect in any event (see pp. 37-41, *infra*).

<sup>26</sup> There is no merit to petitioner's argument that KFS has waived the right to rely on petitioner's clear waiver of all choice of law issues because KFS's brief in opposition to the petition for writ of certiorari purportedly "did not suggest that consideration of Maryland law was barred because of lateness" (Pet. Br. 13). Petitioner's argument implies that her petition sought review on the theory that the Seventh Circuit applied federal common law when it should have applied Maryland law. This implication is false. Petitioner sought review in this Court on the theory that the Seventh Circuit's abolition of the futility exception conflicted with prior decisions of this and other federal courts (Pet. 5-12). In making that argument, petitioner merely noted that the Seventh Circuit had declined to "consider the impact of Maryland law" on waiver grounds (Pet. 8-9). However, petitioner did not raise the Seventh Circuit's failure to adopt Maryland law as a ground for granting review, and she did not begin to argue that Maryland law applied until her merits brief. The purported "error" was not assigned as a ground for this Court to grant review. Thus, there was no need for KFS to state

(footnote continues)

In holding that petitioner's argument came too late, the Seventh Circuit followed the neutral and established rule that federal appellate courts should not consider issues not raised and decided below. The courts of appeals uniformly have applied this rule, both as a general matter and with respect to choice of law issues in particular.<sup>27</sup>

Moreover, even if the courts below erred in applying federal law, that "error" was induced by petitioner and cannot now be urged as a basis for reversal, or even remand, of this case. See, e.g., *McPhail v. Municipality of Culebra*, 598 F.2d 603, 607 (1st Cir. 1979) (a party may not appeal from an error to which he contributed, either by failing to object or by affirmatively presenting the wrong law). *Accord Thunderbird, Ltd. v. First Fed. Sav. & Loan Ass'n*, 908 F.2d 787, 794 (11th Cir. 1990); *Brown v. Syntex Laboratories, Inc.*, 755 F.2d 668, 674 (8th Cir. 1985); *Director General of the India Supply Mission v. Steamship Maru*, 459 F.2d 1370, 1377 (2d Cir. 1972), cert. denied, 409 U.S. 1115 (1973).

Having asked the district court to apply federal law, petitioner had no right to object when the court did so. Nor did petitioner make that objection. Thus, neither petitioner nor the Commission may now raise that issue. This Court's consideration of that issue at this point would subvert settled and fundamental principles which are essential to the fair,

(footnote continued)

in its opposition that petitioner had waived the contention that Maryland law applied. For this reason, petitioner's citation (Pet. Br. 13) to Rule 15.1 is inapposite. The petition correctly stated that the court of appeals had deemed the choice of law issue to have been waived; hence, there were no "misstatements of facts or law" on this score that KFS was required to correct.

<sup>27</sup> See *Michigan Chem. Corp. v. American Home Assur. Co.*, 728 F.2d 374, 377 (6th Cir. 1984); *Reynolds v. American-Amicable Life Ins. Co.*, 591 F.2d 343, 344 (5th Cir. 1979); *Bilancia v. General Motors Corp.*, 538 F.2d 621, 623 (4th Cir. 1976) (per curiam); *Michael-Regan Co. v. Lindell*, 527 F.2d 653, 656 (9th Cir. 1975); *Pellerin Laundry Mach. Sales Co. v. Reed*, 300 F.2d 305, 309-10 (8th Cir. 1962).

just, and efficient administration of justice in the lower federal courts.

**B. The Application Of Federal Law Is Proper Because Demand Is An Exhaustion Requirement That Is A Product Of Federal Common Law.**

Even if petitioner had not waived her right to argue that Maryland law should apply, the courts below correctly chose to apply federal law. The demand requirement had its inception in *Hawes* as a rule created under federal common law to require a shareholder to "exhaust" intracorporate means of resolving disputes before coming to federal court. Because the demand requirement is itself a creature of federal common law, it necessarily follows that the parameters of this requirement — including the existence *vel non* of a futility exception — also must be determined under federal law.

The Commission concedes (SEC Br. 13) that federal law must govern the demand issue because the cause of action involved here arises under a federal statute. See, e.g., *Clearfield Trust Co. v. United States*, 318 U.S. 363, 366 (1943); *Burks*, 441 U.S. at 476; *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942). In this case, assuming that an independent right of action does exist under Section 20(a) (see p. 43, n.33, *infra*), it is a creature of federal statutory law. The scope of that federal right, and the conditions to be imposed upon its exercise, are federal questions governed by federal law.

However, petitioner and the Commission both contend (Pet. Br. 8-11; SEC Br. 14-16) that the case at bar implicates uniquely local concerns and requires, under the analysis in *Burks*, that state law be used as the federal rule of decision. This contention misconceives both the *Burks* analysis and the nature of the demand requirement.

In *Burks*, this Court was called upon to ascertain what law should apply in determining the standards to which a committee of independent directors should be held when it

seeks to terminate a derivative suit. 441 U.S. at 475. Noting that "state law . . . is the font of corporate directors' powers," the Court concluded that the issue of when directors' business judgment is entitled to preclude further litigation was an issue of corporate authority indisputably rooted in state law. Thus, the Court held that that issue should be resolved by reference to state law, unless that law conflicted with the federal regulatory scheme which gave rise to the cause of action. *Id.* at 478-80.

Neither the holding nor the reasoning of *Burks* is applicable here. Unlike *Burks*, this case does not involve the power of directors to dismiss and forever bar a derivative suit. The futility exception to the demand requirement does not deal with the power of directors, but with a prerequisite to filing suit in federal court.<sup>28</sup> Moreover, unlike the directors' right to dismiss a derivative suit, the demand requirement does not spring from "the font" of state law. In federal cases, the requirement that a demand be made on directors flows from *Hawes*, which was based on federal common law. Most assuredly, federal courts may set requirements for the filing in federal courts of derivative actions based on federal law.<sup>29</sup>

<sup>28</sup> This is in contrast to the question of demand on shareholders which, "unlike the demand on directors, is intertwined with the substantive law of corporations dealing with the power of shareholders to ratify 'fraud.'" 3B J. Moore, *Moore's Federal Practice* ¶ 23.1.19 at 94 (1990).

<sup>29</sup> Ignoring these critical distinctions, the Commission conclusorily announces that "*Burks* governs the issue of director demand" (SEC Br. 15). However, it would seriously misread *Burks* to suggest that simply because corporations are creatures of state law, every federal rule or requirement that in any way affects corporations necessarily must draw its meaning from state law.

*Burks* does not sweep so broadly. This Court's analysis did not end with the mere observation that corporations are creatures of state law, but instead focused on whether the particular rule at issue — in *Burks*, the right of directors to terminate litigation — found its source in state law. Finding that it did, the Court observed that state law would

(footnote continues)

Indeed, few matters are more federal in character than the power of the federal courts to fashion rules relating to the administration of proceedings before them, a principle that applies with particular force in federal question cases. Here, as in other contexts involving peculiarly federal interests, the paramount importance of a uniform federal common law rule is manifest. See, e.g., *Clearfield Trust*, 318 U.S. at 366-67 (rights and duties of United States concerning commercial paper); *West Virginia v. United States*, 479 U.S. 305, 308-09 (1987) (interest due for delayed payment of contractual obligation to United States). As this Court has stated in another context (*Hanna v. Plumer*, 380 U.S. 460, 472-73 (1965) (citation omitted)):

One of the shaping purposes of the Federal Rules is to bring about uniformity in the federal courts by getting away from local rules. This is especially true of matters which relate to the administration of legal proceedings, an area in which federal courts have traditionally exerted strong inherent powers completely aside from the powers Congress expressly conferred in the Rules.

Although *Hanna* addressed the applicability of the federal rules in diversity cases, the principle that it confirms — that the administration of legal proceedings in a federal court is a matter with respect to which the importance of uniform rules is well-established — applies with even greater force to the exhaustion requirement involved here.

It cannot be the case that this Court, having created the demand rule as a matter of federal common law, is now powerless under that same common law to make adjustments needed to ensure the rule's continued viability. If that were

(footnote continued)

govern the rule unless it conflicted with the federal regulatory scheme under the 1940 Act. The Commission fails to acknowledge that the demand requirement does not stem uniquely from state law, but is rooted in the federal common law doctrine established in *Hawes*.

the case, federal law would be held hostage to — and perhaps be nullified by — whatever the 50 states variously may decide to do regarding a futility exception. This Court should reject the analysis offered by petitioner and the Commission, which would lead inexorably to this untenable result.

Moreover, application of the laws of the various states is singularly inappropriate because “‘their application would be inconsistent with the federal policy underlying the cause of action.’” *Burks*, 441 U.S. at 479 (citations omitted). Indeed, one need look no further than the Commission’s *amicus curiae* brief in *Lampf Pleva Lipkind Prupis & Petigrow v. Gilbertson*, No. 90-333 (“*Lampf Br.*”), to ascertain why the demand requirement must be governed by a uniform federal rule.

As the Commission stated in *Lampf*, there is a “federal interest in uniform and efficient enforcement of the securities laws throughout the Nation” because only federal law can “provide a promising source for a uniform, predictable rule” (*Lampf Br.* 4, 12). Applying the laws of 50 states rather than uniform federal law would result in “‘complex and expensive litigation over what should be a straightforward matter.’” *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 154 (1987) (citation omitted).

This federal policy, which the Commission correctly articulated in *Lampf*, is particularly strong in this case, which involves a fund operating under a federal statute which makes its directors “watchdogs.” *Burks*, 441 U.S. at 484-85. Under the 1940 Act, Congress has mandated that a substantial percentage of these watchdog-directors be independent. 15 U.S.C. § 80a-10(a). A uniform federal law concerning demand is necessary to ensure that derivative litigation is allowed to proceed, but only in a way that does not usurp the watchdog role which Congress has conferred on the directors.

Thus, federal law must govern, so that “federal policy and the efficiency of litigation [will not be] impaired by the

borrowing of state law” (*Lampf Br.* 16-17). Only through application of federal law will the intent of Congress be realized, and the federal courts’ prerogative to regulate the proceedings before them upheld.<sup>30</sup>

**IV. THE CONTENTION THAT ALL SECTION 20(a) CLAIMS ARE DIRECT RATHER THAN DERIVATIVE, WHICH THE COMMISSION ALONE SEEKS TO ASSERT, NEVER HAS BEEN RAISED BY ANY PARTY AND IS NOT PROPERLY BEFORE THIS COURT.**

The principal thrust of the Commission’s *amicus curiae* brief (SEC Br. 7-13) is to invite this Court to ignore the opinions of both courts below and instead to decide this case on a ground that never has been raised in this case by any party, from the first day of this litigation to the present. The Commission asserts that because the Section 20(a) claim involves a proxy issue, it “is not subject to a requirement that the shareholder must make demand on the directors as a prerequisite to maintaining the action” (SEC Br. 7-8). For at least three reasons, this new issue, which is framed and urged only by the Commission, is not properly before the Court and should not be considered.

First, the Commission’s new issue is not, under Rule 14.1, “fairly included” in the question upon which review was granted. The question states (Pet. i):

As a prerequisite to bringing a shareholder action on behalf of an investment company to recover damages for proxy fraud under Section 20 of the Investment Company Act, must the shareholders first make a demand upon the company’s directors to bring the action even where such a demand would be futile?

<sup>30</sup> Even if this Court should find state law applicable, the judgment should be affirmed because petitioner’s allegations fail to meet the requirements of the futility exception even under Maryland law (*see pp.* 17-19, *supra*).

This question does not seek review as to whether a proxy claim can be asserted derivatively. Had petitioner sought review of that question, she would not have characterized the Section 20 claim as one "on behalf of an investment company." Nor would she have included the last phrase of her question presented, which undeniably refers to the futility exception.<sup>31</sup>

Indeed, the Commission admits (SEC Br. 8 n.5) that petitioner consistently and unequivocally pleaded the Section 20(a) claim as a derivative claim in the district court, and in the court of appeals expressly conceded that the claim was derivative by admitting the applicability of Rule 23.1. In this Court as well, petitioner never has argued that the Section 20(a) claim should be treated as a direct rather than a derivative action — not in her petition, not in her reply in support of the petition, and not in her merits brief. Petitioner's failure ever to raise this argument underscores that the Commission's new issue is not fairly included within the question presented for review.

Second, this Court has long recognized the compelling nature of those prudential considerations which counsel the Court to decline invitations to decide issues not raised or decided in the courts below. *See, e.g., DeShaney v. Winnebago County Dep't of Social Servs.*, 489 U.S. 189, 195 n.2 (1989). Those prudential considerations apply with special force where the new issue is raised only by an *amicus*. *United Parcel Serv. v. Mitchell*, 451 U.S. 56, 60 n.2 (1981); *Bell v.*

<sup>31</sup> The Commission itself has framed the question in the same way: "[w]hether a shareholder alleging a proxy violation under Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), and seeking relief in favor of the investment company, is required by federal law to make a demand on the directors of the company to bring the action even when such a demand would be futile" (SEC Br. i).

*Wolfish*, 441 U.S. 520, 531-32 n.13 (1979); *Knetsch v. United States*, 364 U.S. 361, 370 (1960).<sup>32</sup>

Third, the Commission is incorrect in asserting that the Court should consider its new issue on the ground that it is "antecedent" to the question upon which this Court granted review (SEC Br. 8 n.5). At the threshold, it is curious that the Commission urges consideration of the allegedly "antecedent" question whether Section 20(a) claims ever may be derivative, without suggesting that the Court consider the more basic question whether Section 20(a) can support any implied right of action, derivative or direct.<sup>33</sup>

Moreover, if the concept of "antecedent" questions were as elastic as the Commission suggests, it would encompass virtually every legal question that could have been raised in a case. Few questions, if any, ever would be deemed waived. In addition, and contrary to first principles of appellate practice, the issues involved in litigation would become broader — not narrower — as a case proceeded through successive levels of appellate review. Indeed, that is the untoward result that petitioner and the Commission seek to accomplish in this case. (*See pp. 8-9, supra.*) At the very least, the idea that only jurisdictional issues are immune from waiver would become

<sup>32</sup> We have found only three occasions on which this Court has addressed issues which arguably were urged only by an *amicus*. *See Batson v. Kentucky*, 476 U.S. 79, 83-85 & n.4, 109 (1986); *Teague v. Lane*, 489 U.S. 288, 300 (1989); *Mapp v. Ohio*, 367 U.S. 643, 645-46 & n.3, 655 (1961). Unlike the case at bar, each of these cases involved constitutional issues. In addition, the issues decided in these cases had been raised below, or the questions presented by the parties were broad enough to encompass the grounds urged by *amici*.

<sup>33</sup> KFS argued below that where, as here, an action seeks only return allegedly excessive adviser fees, the exclusive remedy is Section 36(b). The district court rejected that argument (Pet. App. 39a-46a), and the Seventh Circuit found it unnecessary to reach (Pet. App. 7a). This Court has yet to decide whether any implied private right of action exists under Section 20(a), *Burks*, 441 U.S. at 475-76 & n.5, or how the specific remedy provided by Section 36(b) would affect any right of action that might be implied under Section 20(a).

a quaint remnant. If the Commission were correct, jurisdictional issues would be indistinguishable, as a practical matter, from a countless variety of other issues which also would be saved on the ground that they are "antecedent."<sup>34</sup>

At all events, the Commission's "antecedent" argument is based on a completely unwarranted premise. The Commission presumes that a proxy claim may never be a derivative action, and that questions of demand and futility should not therefore be reached. In turn, the notion that a proxy claim may never be a derivative action is premised on the Commission's erroneous view that a corporation never could bring a proxy claim (SEC Br. 7-8).

The Commission cites no case law, and we are aware of none, which holds that a proxy claim — whether under Section 20 of the 1940 Act or Section 14 of the 1934 Act — never may be brought by a corporation. Indeed, the Commission acknowledges that this Court in *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964), recognized that implied rights of action for proxy violations may be derivative as well as direct (SEC Br. 12). As the Court stated in *Borak* (377 U.S. at 432):

The injury which a shareholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the

<sup>34</sup> This Court frequently has refused to reach non-jurisdictional "antecedent" questions which have not been argued or decided below. One example is *Burks*, in which this Court assumed the existence of implied rights of action under the 1940 Act. The Court noted that "[t]he question whether a cause of action exists is not a question of jurisdiction, and therefore may be assumed without being decided." 441 U.S. at 476 n.5 (citations omitted). The prudential considerations counseling against deciding newly raised issues are so strong that even jurisdictional "antecedent" questions have been left for another day. *E.g.*, *United States v. Verdugo-Urquidez*, \_\_\_\_ U.S. \_\_\_\_, 110 S. Ct. 1056, 1064-65 (1990).

corporation, rather than from the damage inflicted directly upon the shareholder.<sup>35</sup>

The Court rejected the argument that a private right of action under Section 14(a) "would not extend to derivative suits." *Id.* at 431. The Court reasoned that "[t]o hold that derivative actions are not within the sweep of the action would therefore be tantamount to a denial of private relief." *Id.* at 432.

The Commission fails to note that, consistent with *Borak*, corporations often have brought claims for proxy violations and that shareholders have brought such claims derivatively.<sup>36</sup> Indeed, that the proxy claim can belong to the corporation is underscored by the fact that courts have given

<sup>35</sup> The Commission asserts, *ipse dixit*, that the Court in *Borak* probably did not have in mind "true derivative actions," and suggests that, if it did, then the decision would not square with the "contemporary jurisprudence" reflected in *Fox* (SEC Br. 12 n.9). The Commission cites *Fox* for the proposition that "not all suits seeking a recovery for the benefit of the corporation qualify as derivative actions in the relevant sense" (SEC Br. 12-13).

The Commission's characterization ignores the fact that this Court in *Fox* did not address Section 20(a), but "the unusual cause of action created by § 36(b)." 464 U.S. at 535. Section 36(b) provides that such suits may be brought only by a shareholder or the Commission. Since the directors have no power to bring suit on behalf of the corporation, no purpose would be served by requiring a demand under Section 36(b). *See id.* at 542. By contrast, Congress did not confer the right to bring Section 20(a) claims only on certain parties. Thus, *Fox* cannot be read to suggest that a Section 20(a) claim could not be brought by a corporation.

<sup>36</sup> For example, in *King v. Kansas City Southern Indus.*, 56 F.R.D. 96 (N.D. Ill. 1972), *aff'd*, 519 F.2d 20, 26-27 (7th Cir. 1975), four mutual funds pursued actions under Section 20(a) alleging, among other things, that the defendants — including the investment adviser — had caused a misleading proxy to be sent to shareholders. The district court squarely recognized the right of the funds to pursue this action; indeed, the court denied a request by certain shareholders to litigate the case as a class action, and stayed proceedings on derivative actions filed by other shareholders. 56 F.R.D. at 102.

(footnote continues)

*res judicata* effect to an earlier dismissal of the same Section 14(a) claim brought by another shareholder. In *Cramer v. GTE Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979), for example, the court dismissed a proxy action brought by a second shareholder after an earlier shareholder action had been resolved, recognizing that "[a]lthough different shareholders brought the two actions, the actual plaintiff on whose behalf the claims were brought is the identical corporation, GTE." *Id.* at 267; *see also Gerrity v. Chapin*, 1980 WL 1364 (S.D.N.Y. 1980) (available on Westlaw).

In the case at bar, the Fund clearly could have considered the option of filing a proxy claim, if a demand had been made. The only injury alleged in the complaint is that the Fund was charged excessive fees (Pet. App. 91a). This alleged injury is one which would be suffered by all shareholders alike, according to their percentage ownership in the Fund. Petitioner did not allege that she suffered any injury separate and distinct from that suffered by all shareholders, and she sought no separate remedy. The only relief she specifically

(footnote continued)

Other cases also have recognized that, under *Borak*, proxy claims may be brought derivatively by shareholders or directly by the corporation itself. *See, e.g., Studebaker Corp. v. Gittlin*, 360 F.2d 692, 695 (2d Cir. 1966) (if Section 14(a) of the 1934 Act "authorizes a stockholder to assert such a [proxy] claim on the corporation's behalf, as held in *Borak*, it must also authorize the corporation to do so on its own"); *Management Assistance, Inc. v. Edelman*, 584 F. Supp. 1016, 1017 (S.D.N.Y. 1984) (Section 14(a) claim by corporation); *International Broadcasting Corp. v. Turner*, 734 F. Supp. 383, 385, 389-90 (D. Minn. 1990) (Section 14(a) claim by corporation); *Ameribanc Invs. Group v. Zwart*, 706 F. Supp. 1248, 1249 (E.D. Va. 1989) (Section 14(a) claim by corporation); *National Home Prods., Inc. v. Gray*, 416 F. Supp. 1293, 1297 (D. Del. 1976) (Section 14(a) claim by corporation against certain of its directors); *Lewis v. Anselmi*, 564 F. Supp. 768, 771-73 (S.D.N.Y. 1983) (derivative claim under Section 14(a)); *Lewis v. Valley*, 476 F. Supp. 62, 64 (S.D.N.Y. 1979) (derivative claim under Section 14(a)).

requested was that KFS be required "to pay to the Fund its damages" (Pet. App. 93a).<sup>37</sup>

As a practical matter, a corporation can pursue a number of other possible remedies to address an injury from an alleged proxy violation. However, a corporation's election of other remedies does not alter the fact that the proxy claim is a right "which properly may be asserted by it [the corporation]." Fed. R. Civ. P. 23.1. Demand is required to ensure that the corporation is afforded the opportunity to consider whether to sue or to pursue other options.<sup>38</sup>

In sum, the major premise of the Commission's so-called "antecedent" argument — that a corporation may never file a proxy claim — is untenable. Because this premise fails, so too does the Commission's "antecedent" argument. This Court therefore should decline the Commission's invitation to decide an issue which has never been litigated by the parties, or addressed or decided by the courts below.

<sup>37</sup> The Commission asserts that the relief sought does not determine whether a claim is derivative (SEC Br. 14-15). But the Commission ignores the fact that the relief sought typically reflects the nature of the injury suffered. And it is a "general precept of corporate law that a shareholder of a corporation does not have a personal or individual right of action for damages based solely on an injury to the corporation." *Gaff v. FDIC*, 814 F.2d 311, 315 (6th Cir.) (collecting authorities), *reh'g on other grounds*, 828 F.2d 1145 (1987); *see also* 12B Fletcher, *Cyclopedia of the Law of Private Corporations* § 5911 at 421 (1984) (footnote omitted) (an action is derivative "if the gravamen of the complaint is injury to the corporation"). It is equally clear that a depreciation or diminution in the value of a shareholder's stock is not the kind of "direct, personal injury which is necessary to sustain a direct cause of action." *Gaff*, 814 F.2d at 315 (citations omitted); 12B Fletcher, *Cyclopedia of the Law of Private Corporations* § 5911 at 421 (1984) (an action is derivative "if it seeks to recover assets for the corporation or to prevent the dissipation of its assets").

<sup>38</sup> As the foregoing discussion demonstrates, the Commission's new issue would not have warranted review by this Court even if it properly had been presented in a petition for a writ of certiorari. *See Sup. Ct. R.* 10.1.

### CONCLUSION

For all of the foregoing reasons, the judgment of the court below, affirming the dismissal of petitioner's Section 20(a) claim, should be affirmed.

Respectfully submitted,

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## APPENDIX

15 U.S.C. § 80a-2(a)(19)(B) provides in relevant part that:

When used in this subchapter, unless the context otherwise requires . . . "Interested person" of another person means . . . when used with respect to an investment adviser of or principal underwriter for any investment company —

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

15 U.S.C. § 80a-10(a) provides that:

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

15 U.S.C. § 80a-15(c) provides that:

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as an investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.